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IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. 524 20

CARL E. WELLER and EMILY P. WELLER,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

RICHARD H. APPERT,
Counsel for Petitioners,
14 Wall Street,
New York 5, New York.

Of Counsel:
HARRY A. DOWER,
DAVID SACHS.

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioners pray that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit, entered on September 9, 1959.

Opinions Below

The opinion of the Tax Court of the United States is reported at 31 T. C. 33 (1958).[1] The opinion of the Court of Appeals is reported at 270 F. 2d 294, 59-2 C.C.H.-U.S.T.C. ¶ 9667, 4 P-H A.F.T.R. 2d 5453 (1959), and is printed in Appendix A, *infra*, p. 17.

1. The Tax Court opinion in the present case and in its companion case, *Stuart Emmons*, 31 T. C. 26 (1958), are contained in the printed appendix for the use of the court below, pp. 69a-84a.

Jurisdiction

The judgment of the Court of Appeals was rendered on September 9, 1959 and was entered by the Clerk on the same day. The jurisdiction of this Court is based on 28 U. S. C. §1254(1).

Questions Presented

1. Is it necessary that there be an economic purpose for making a payment of interest in order that the interest payment be deductible from gross income for federal income tax purposes?

2. (a) Was there no economic purpose in the prepayment by one of the petitioners of the premiums on an annuity policy and in the payment of interest by him on an insurance company loan secured by said paid-up annuity policy merely because the major part of the expected profit would be realized only if the interest was deductible for tax purposes?

(b) Was the amount paid as interest on the insurance company loan deductible for federal income tax purposes?

3. May the respondent reverse retroactively as to the petitioner his established administrative policy, evidenced by numerous letter rulings issued to persons other than the petitioner and relied on by the petitioner, of allowing the deduction of interest paid in transactions indistinguishable from the transactions entered into by the petitioner.

Statutes Involved

The statute directly involved in this proceeding is section 23(b) of the Internal Revenue Code of 1939, 53 Stat. 12 (1939), 26 U. S. C. A. (I. R. C. 1939) §23(b) (1955):

> "Sec. 23. Deductions From Gross Income.
>
> "In computing net income there shall be allowed as deductions:
>
> • • •

"(b) Interest.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter."

Also relevant to this case are: section 24(a)(6) of the Internal Revenue Code of 1939, added by 56 Stat. 827 (1942), 26 U. S. C. A. (I. R. C. 1939) §24(a)(6) (1955); section 3791(b) of the Internal Revenue Code of 1939, 53 Stat. 467 (1939), 26 U. S. C. A. (I. R. C. 1939) §3791(b) (1955); section 163(a) of the Internal Revenue Code of 1954, 68A Stat. 46 (1954), 26 U. S. C. §163(a) (1958 ed.); section 264(a)(2) of the Internal Revenue Code of 1954, 68A Stat. 77 (1954), 26 U. S. C. §264(a)(2) (1958 ed.); and section 7805(b) of the Internal Revenue Code of 1954, 68A Stat. 917 (1954), 26 U. S. C. §7805(b) (1958 ed.). These sections are printed in Appendix B, *infra*, p. 29.

Statement

The petitioners herein are husband and wife, residing at 3276 Nazareth Road, Easton, Pennsylvania. Their joint federal income tax return for the calendar year 1952 was filed with the Director of Internal Revenue for the District of Scranton, Pennsylvania. By notice dated November 21, 1955, the respondent determined a deficiency in income tax of the petitioners for the calendar year 1952 in the amount of $28,154.10. This asserted deficiency resulted principally from the disallowance of a deduction for $40,050.06 interest paid to a life insurance company on an annuity policy loan. The disallowance of this interest deduction is the only item in dispute in this case.

The taxpayers petitioned the Tax Court of the United States for a redetermination of the asserted deficiency.

The jurisdiction of the Tax Court was based on section 272(a)(1) of the Internal Revenue Code of 1939 and 26 U. S. C. §7442. That court rendered a decision that the interest was not deductible and that there existed a deficiency in the amount stated by the respondent. On appeal to the United States Court of Appeals for the Third Circuit, the decision of the Tax Court was affirmed.

The facts of the present case are as follows:

On October 3, 1952, petitioner Carl E. Weller (hereinafter referred to as "the petitioner") applied to the Standard Life Insurance Company of Indiana (hereinafter referred to as "the insurance company") for an annuity contract. On October 6, 1952, the petitioner issued a check in the amount of $20,000 to the insurance company in payment of the first of 41 annual premiums due on the contract. On October 10, 1952, the insurance company issued to the petitioner an annuity contract providing for monthly payments, to be not less than 120 payments of $6,454.34 each, beginning October 10, 1993, each payment to be made to the petitioner's daughter, Janet E. Weller. During the life of the petitioner all rights of every kind in the contract, including the right to receive income under the optional settlement provisions, were reserved to him, could be exercised by him without the consent of his daughter, and would vest in her only if the petitioner should predecease her.

On November 24, 1952, the petitioner borrowed $473,713.42 from The Philadelphia National Bank, Philadelphia, Pennsylvania, giving his personal note payable on demand and pledging as collateral security the annuity contract. Subsequently, on November 24, 1952, the petitioner paid to the insurance company the amount of $473,713.42 in full satisfaction of all premiums to become due under the annuity contract, by having The Philadelphia National Bank credit the amount of $473,713.42 to the insurance company's account with that bank. After that payment, the

petitioner owned a fully paid annuity contract with a cash or loan value of $489,214. Subsequently, on November 24, 1952, the petitioner borrowed $489,214 from the insurance company and executed an agreement with the insurance company covering the loan and designated by the parties as an "Annuity Loan Agreement."

Subsequently, on November 24, 1952, the petitioner paid to The Philadelphia National Bank the amount of $474,081.86 in full satisfaction of all amounts due the bank, including interest charges of $52,63[illegible] and clearance charges of $315.81.

On November 24, 1952, the petitioner paid $19,192.24 to the insurance company for which the insurance company gave a receipt which designated the amount as "Annuity Loan interest 51 weeks to 10-10 1953." On December 15, 1952, the petitioner paid $20,857.82 to the insurance company for which the insurance company gave a receipt which designated the amount as "Interest on annuity loan #57089 to 10 Oct 1954." The total of these two interest payments, $40,050.06, was deducted by the petitioner from gross income as "interest" on his 1952 income tax return filed jointly with his wife.

On December 15, 1952, the petitioner borrowed an additional $17,715, from the insurance company and executed a new agreement with the insurance company designated by the parties as an "Annuity Loan Agreement", covering the entire $506,929, to which the loan had been increased. Pursuant to the terms of the Annuity Loan Agreements, the petitioner assigned the annuity contract to the insurance company as security for the annuity loans.

Before having purchased the annuity contract, the petitioner had discussed the federal income tax aspects of the purchase of the policy, the prepayment of premiums, the obtaining of loans from the insurance company, and the

2. This amount of $52[illegible] was claimed as interest disallowed by respondent

prepayment of interest to the insurance company with the local general agent of the insurance company and with the two brokers for the contract. In the course of these discussions the petitioner was shown copies of seven letter rulings issued to various taxpayers by the United States Treasury Department, the first of which was dated October 16, 1947, and the last of which was dated August 1, 1952. It was stated in these rulings that interest paid on a loan secured by an annuity policy on which premiums had been prepaid is deductible for federal income tax purposes. In three of the rulings the lenders were banks; in two, the lenders were stated alternatively to be banks or the issuing insurance companies; in two, the lenders were the issuing insurance companies. Two of these rulings, one with a bank as lender and the other with the issuing insurance company as lender, had been issued to the local general agent of the insurance company who was one of the persons with whom the petitioner had discussed the federal income tax implications of the transactions.

After the petitioner had purchased the annuity policy but before he had borrowed any money to prepay premiums or had paid any interest to the insurance company, one of the two brokers for the annuity contract exhibited to the petitioner a ruling issued to one Williams, dated November 6, 1952, and holding deductible interest paid to an insurance company on a loan secured by an annuity policy where the premiums on such policy had been prepaid for a number of years. The petitioner knew of Williams, knew that the broker had been negotiating with Williams regarding Williams' prospective purchase of an annuity contract from the same insurance company similar to that purchased by the petitioner, and knew that Williams was applying for a Treasury Department ruling with respect to the proposed transaction.

In making the loans on the policy, paying the interest to the insurance company and deducting the amounts paid in 1952, the petitioner relied on the existing administrative interpretation of the law as set forth in the Williams ruling and the other rulings which he had been shown. He had already owned the annuity policy for about a month and a half at the time of the November 24, 1952, loan made to prepay the annuity premium, and he would not have made the loan if he had not been led to believe by the rulings that the interest payments would be deductible for income tax purposes. Since the discount on prepaid premiums was 2.85% compounded, it would not have paid him to make the loan at 4% to prepay the premiums, unless the interest on the loan was deductible so that the net cost after taxes was less than 2.85%. The discount on the premiums would have been even more profitable, of course, if he could have paid off the loan and avoided the interest altogether. At the time of taking out the loan, the taxpayer intended to repay it at such time in the future as he should have available sufficient cash, which he anticipated he would obtain from the sale of certain stock held by him.

REASONS FOR GRANTING THE WRIT

1. The decision of the United States Court of Appeals for the Third Circuit in the present case conflicts with the decision of the United States Court of Appeals for the Fifth Circuit in *United States* v. *Bond*, 258 F. 2d. 577 (5th Cir. 1958).

In *United States* v. *Bond*, 258 F. 2d 577 (5th Cir. 1958), the United States Court of Appeals for the Fifth Circuit was presented with a fact situation substantially similar to that in the present case. The taxpayer, Bond, had purchased in 1952 from a Texas insurance company a single premium, thirty-year maturity, "Annuity Savings Bond"

with a cash value at maturity of $209,700.[3] This "Annuity Savings Bond" was an annuity contract, similar to the one in the present case, providing for a monthly payment of an annuity to the beneficiary beginning on the thirtieth anniversary of its purchase. Bond paid $100 to the insurance company and executed a note to the company for $100,000; to complete the full payment of the single premium of $100,100. During 1952 Bond paid to the insurance company $2,750 as interest in advance on the note, and deducted that amount on his federal income tax return as interest, pursuant to section 23(b) of the Internal Revenue Code of 1939. The deduction was disallowed by the Commissioner of Internal Revenue. Bond paid the additional tax assessed and sued for a refund in the United States District Court for the Southern District of Texas. The District Court held that the interest was deductible under Section 23(b) of the Internal Revenue Code of 1939 and entered judgment for Bond.

On appeal by the Commissioner, the Fifth Circuit affirmed. The Fifth Circuit reasoned (1) that the transaction was not a sham or an artificial transaction as the Commissioner contended, but a legitimate purchase on credit of a valid and enforceable single-premium annuity contract from an insurance company operating in accordance with the insurance law of Texas, and (2) that the legislative history of sections 23(b) and 24(a)(6) of the 1939 Code and corresponding sections 163, 264, and 265 of the 1954 Code indicated that interest paid on indebtedness incurred in the purchase of such a contract was deductible under section 23(b) of the 1939 Code.

The *Bond* case, if at all distinguishable from the present case, is even more favorable to the Commissioner's

3. Bond purchased seven of these "Annuity Savings Bonds" but the Fifth Circuit, for ease of discussion, referred to only one. We shall do the same.

position than is the present case. In *Bond*, all but an insignificant part of the initial payment on the policy was made with a note to the insurance company; in the present case, the taxpayer made the initial payments partly from his own funds ($20,000) and partly from funds borrowed from a commercial bank ($473,713.42).[4] Nevertheless, in the present case, the Third Circuit affirmed the Tax Court's determination in favor of the Commissioner disallowing the interest deduction. In so doing, the Third Circuit referred to *Bond* and expressly disagreed with it:

> "We are not unmindful of the decision recently rendered by the Court of Appeals for the Fifth Circuit in a similar case, United States v. Bond, 258 F. 2d 577, (1958), which holds contrary to this opinion. We agree, however with the dissenting opinion of Judge Wisdom in that case."[5]

The Third Circuit differed from the Fifth Circuit's view that the policy purchase and interest payment were not artificial transactions; instead it approved the Tax Court's conclusion that although the transactions actually took place, they lacked substance because there was no "independent economic purpose" aside from the creation of a tax deduction. The Third Circuit also summarily dismissed the taxpayer's argument (which was the other ground of the Fifth Circuit's decision) that the legislative history of the interest sections indicated a legislative intention that interest be deductible when paid on indebtedness incurred to purchase a single premium annuity contract. In this connection, the Third Circuit ignored completely the significance of the provision in section 264(a) of the 1954 Code which disallows interest de-

4. The Fifth Circuit did not consider that a significant distinction, and it rejected the government's argument that it was significant. 258 F. 2d at 580.

5. 270 F. 2d at 299.

ductions with respect to such indebtedness only as to annuity contracts purchased after March 1, 1954 (a provision stressed in the *Bond* case). Thus, there is a direct conflict between the Circuits not only in result, but in the reasoning underlying the result.

2. The issues decided in the present case are important questions involving the federal income tax laws which have not been, but should be, settled by this Court.

a. The deductibility of the interest payments.

The primary issue in the present case, and the one with respect to which the conflict between Circuits exists, is the question of whether the taxpayer may deduct, under section 23(b) of the Internal Revenue Code of 1939, the interest payments he made in 1952 to the insurance company on the annuity policy loans. The reasoning of the Third Circuit in deciding this question in the negative has implications extending far beyond the area of single premium annuity contracts. The Third Circuit, citing *Gregory* v. *Helvering*, 293 U. S. 465 (1935), broad statements in several other Supreme Court decisions involving sham conveyances of title, and Judge Learned Hand's dissent in *Gilbert* v. *Commissioner*, 248 F. 2d 399, 411-12 (2d Cir. 1957), imposed upon section 23(b) a requirement that there be an "independent economic purpose" other than a tax avoidance motive in order for the interest deduction to be available. Unlike the business expense class of deductions, the language of section 23(b) had no requirement of business or economic purpose. It simply provided a deduction for "all interest paid or accrued within the taxable year on indebtedness," with certain specified exceptions not relevant here. The interest deduction is available to all taxpayers who borrow money

and, prior to the present decision, without regard to the purpose for the borrowing (except for the specific exceptions listed in the tax statutes) or the economic benefit from the loan. To take the most extreme example, if a person borrows money at interest and hides the money under his mattress, should he not be permitted to deduct the interest? Or, to be more realistic, if a person borrows money from a bank at interest and leaves it on deposit with the bank in a noninterest bearing checking account for the entire period of the loan, does the fact that he derived no economic benefit from the loan mean that he may not deduct the interest? The Third Circuit seems to say the deduction should be disallowed. If this answer is correct, this Court has not yet said so. If the economic purpose doctrine of *Gregory* v. *Helvering* applies to the interest deduction (and, by implication, to the various other deductions outside the area of business-related expenses, such as the deductions for contributions, taxes, and medical expenses), the Supreme Court should make the pronouncement.

It is submitted that the business purpose rule of the *Gregory* case has no proper application to the interest deduction in the present case. The *Gregory* rule is primarily a rule of Congressional intent. The legislative history of section 23(b) and section 24(a)(6) of the 1939 Code shows a clear Congressional intent to allow the deduction of interest on indebtedness incurred to purchase a single premium annuity policy (as distinguished from a single premium life insurance or endowment policy), and the intent of Congress to allow the deduction of interest in transactions exactly like that of the petitioner with respect to annuities purchased on or before March 1, 1954 is made absolutely clear by the express provision of section 264(a) of the 1954 Code which disallows such interest

deductions only with respect to annuities purchased after March 1, 1954.

Furthermore, in any event, it is submitted that the Third Circuit has extended the *Gregory* decision far beyond its scope. The *Gregory* case involved an attempt to convert what was in substance a conveyance into a tax-free corporate reorganization. The other cases cited in support of the Third Circuit's opinion similarly involve attempts to mold a business transaction into an unnatural form in order to reduce taxes. In none of these cases was there a change, either beneficial or detrimental, in the economic position of the parties in interest, except for the benefit from the favorable tax treatment sought by them. In the present case, on the other hand, although the petitioner's choice of the method of financing his annuity purchase will result in no economic gain to the petitioner if the interest deduction is not allowed, there has been a change in his economic position regardless of tax considerations. The petitioner has subjected himself to an economic loss during the period during which the insurance company loan is left outstanding of the difference between the 4% interest rate on the loan and the 2.85% discount on the prepaid premiums. If the interest deduction is allowed, as it would seem that it should be under the provisions of section 23(b) of the 1939 Code, the net interest cost after taxes will be reduced so as to make his choice of financing profitable. If the interest deduction is not allowed, his choice will result in an economic loss arising from the interest payment. It is clear, therefore, that there has been a real change in the petitioner's economic position and that the *Gregory* rule does not properly require that the petitioner's interest deduction be disallowed.

It is of particular importance that this Court should settle the questions here involved because the Third Circuit's opinion is as applicable to the interest deduction provision currently in effect, section 163(a) of the Internal Revenue Code of 1954, as it is to section 23(b) of the 1939 Code. Although the specific question with respect to interest on indebtedness incurred in acquiring a single premium annuity is settled as to policies purchased after March 1, 1954 by section 264(a)(2) of the 1954 Code, the validity of the economic purpose requirement is still of great significance with respect to the general deduction of interest under section 163(a), including interest deductions relating to annuity contracts purchased on or before March 1, 1954, as to which the disallowance under section 264(a)(2) is expressly nonapplicable.

b. The retroactive reversal of Treasury Department policy with respect to the interest payments.

In addition to the interest deduction issue discussed above, this case presents an important problem with respect to the propriety of a retroactive revocation by the Treasury Department of a policy allowing the interest deduction in cases similar to the present one, declared during the period 1947-1952 in private rulings issued to a number of taxpayers.[6] Although the petitioner did not obtain such a ruling, he could have done so merely by requesting it; instead he relied on the many rulings shown to him, one dated only several weeks before he entered into the loan transaction.

Certain aspects of this problem were considered by this Court in *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180 (1957). In the *Automobile Club* case, this Court indicated that the Commissioner had a duty reasonably to exercise the discretion vested in him by 3791(b)

6 Eight such rulings are included in the record of this case.

of the Internal Revenue Code of 1939[7] to prescribe the extent to which any ruling should be applied without retroactive effect, and that the Commissioner's abuse of this discretion could be remedied in the courts. However, this Court held that, on the facts of that case, it was not an abuse of the Commissioner's discretion to revoke a private exemption ruling and to make the revocation retroactive to a year in which a ruling had been published reflecting the new interpretation upon which the revocation was based.

Although in the present case there was no published ruling until 1954,[8] the Third Circuit held that the Commissioner had not abused his discretion in applying the new policy to the year 1952, and it relied upon the *Automobile Club* case in so holding. This extension of the *Automobile Club* decision is a matter which should be ruled upon by this Court for several reasons. First, the revocation in the present case was not of a ruling involving one taxpayer, as in the *Automobile Club* case, but of a policy established by a series of rulings to many taxpayers over a long period of time. Thus, the content of these rulings, though unpublished, became generally known to the public to an extent similar to that of published rulings. Second, Congress recognized the significance of the retroactivity problem in this type of case by expressly providing in section 264(a) of the Internal Revenue Code of 1954 that the provision denying a deduction for indebtedness incurred in purchasing a single-premium annuity contract "shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954." And, third, to leave standing the holding

7. 53 Stat. 467 (1939), 26 U. S. C. A. (I.R.C. 1939) §3791(b) (1955):

"The Secretary, or the Commissioner with the approval of the Secretary, may prescribe the extent, if any, to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect."

(Now §7805(b) of the Int. Rev. Code of 1954.)

8. Rev. Rul. 54-94, 1954-1 Cum. Bull. 53.

of the Third Circuit would result in increasing the already heavy burden upon the rulings branch of the Internal Revenue Service. The Third Circuit's decision will require every taxpayer, in the absence of a published ruling or regulation, to obtain a personal ruling in order to protect himself, even though the position of the Internal Revenue Service on a certain matter is evident from many private rulings on that matter. Those taxpayers who do obtain a ruling are generally safe from retroactive application of a change in position of the Internal Revenue Service pursuant to the general policy of the Service "to limit the revocation or modification of a ruling issued to, or with respect to, a particular taxpayer to a prospective application only."[9] The obvious discrimination, in cases like the present one, against those taxpayers who did not obtain rulings is a serious matter which should be considered by this Court.

3. The specific issues involved in the present case are common to numerous cases presently in various stages of litigation.

Because of the many private rulings issued by the Internal Revenue Service with respect to transactions similar to the present one, and because of the resultant extensive promotion by insurance agents throughout the country of the credit purchase of single-premium annuity policies, a great number of persons entered into transactions substantially the same as that carried out by the present taxpayer without obtaining a ruling. A tabulation of the reported cases alone shows that four cases similar to the present one have been decided by the Tax Court[10] or United States district courts[11] and several of them are on appeal. In addition to *Emmons* v. *Commissioner*,[12] which was decided by the Third

9. Treas. Reg. 86[1.201-1(a)(4), 26 C.F.R. (1958) 86[1.201-1(a)(4), Rev. 1959].

10. *Robert M. Dinn* 18 CCH T.C.M. 443, 1959 P-H T.C.M. 59092 (June 9, 1959); *Lucien Wilcox* 18 CCH T.C.M. 205, 1959 P-H T.C.M. 59043 (March 3, 1959).

11. *Howard* v. *United States* 59-1 CCH U.S.T.C. 9650, 4 P-H A.F.T.R. 2d 868 (D. Ariz. Feb. 17, 1959); *Roderick* v. *United States* 59-2 CCH U.S.T.C. 9650, 4 P-H A.F.T.R. 2d 5509 (W.D. Tex. Aug. 5, 1959), 272 F. 2d 294 (3d Cir. 1959) (same opinion as in present case).

Circuit together with the present case and which will be before this Court on a petition for a writ of certiorari, there is a decision of the Ninth Circuit in *Knetsch* v. *United States*,[13] entered on November 16, 1959, in which the taxpayer, who lost, may seek certiorari. Petitioners have no way of determining how many additional cases are pending in the Tax Court[14] or in district courts, and how many are at the stage of administrative negotiation between the taxpayer and the Internal Revenue Service, or have not even reached that stage. In these cases, both the taxpayers and the government will be compelled to expend much effort and money if the present issues are not settled by this Court. This will be especially true in cases arising in any of the seven circuits which have not yet ruled on the issues. And even in the other circuits, the possibility that this Court may eventually grant certiorari (if it does not do so now) will lead to much needless litigation. Consequently, it would be to the benefit of both the United States and the many taxpayers who have similar cases that this Court hear and decide the present case.

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13 59-2 CCH USTC ¶9765, 4 PH AFTR 2d 5855 (9th Cir. Nov. 16, 1959).

14 At least twelve cases similar to the present one are pending in the Tax Court. *William K. Carpenter*, Tax Court Dkt. No. 65446; *Robert S. Gilmore*, No. 63088; *William R. Lovett*, No. 71565; *Harry C. Minchin*, No. 72784; *James F. Pierce*, No. 70676; *Harry C. Reamer*, No. 70765; *Donald Reamer*, No. 71787; *Ruth C. Talley*, No. 66655; *Edward R. Schmidt*, No. 63176; *Rudolf Stern*, No. 67317; *Hendrik Van der Hoop*, No. 65677; *Timothy P. Wise*, No. 68948.

CONCLUSION

For the foregoing reasons, this Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

RICHARD H. APPERT,
Counsel for Petitioners.

HARRY A. DOWER,
DAVID SACHS,
Of Counsel.

APPENDIX A

OPINION BELOW

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 12,844

CARL E. WELLER AND EMILY I. WELLER,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. 12,854.

W. STUART EMMONS,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITIONS FOR REVIEW OF DECISIONS OF THE TAX COURT OF THE UNITED STATES

Argued June 9, 1959.

Before BIGGS, *Chief Judge*, and MCLAUGHLIN and STALEY, *Circuit Judges*.

OPINION OF THE COURT.
(Filed September 9, 1959)

BY STALEY, *Circuit Judge*.

Appendix A

These cases present identical questions of law,[1] namely, whether the Tax Court erred in holding that certain transactions involving prepayment of interest on annuity contract loans lacked substance so as not to be deductible as interest payments under Section 23(b) of the Internal Revenue Code of 1939.

The essential facts in the Emmons case, as found by the Tax Court, may be summarized as follows: Emmons, a cash basis taxpayer, purchased an annual premium annuity policy from Standard Life Insurance Company of Indiana in 1951. The policy required forty-one annual payments of $2,500 each, and the initial premium was paid on December 20, 1951, the date of issuance of the policy. The next day Emmons borrowed on his personal note $59,213.75 from the Girard Trust Corn Exchange Bank, pledging the annuity policy as collateral. This sum was credited to the account of the insurance company as a prepayment, at a discount, of all future premiums on the annuity policy.

On December 24, 1951, Emmons paid an additional $13,627.30 to Standard purportedly as interest to December 20, 1956, on an anticipated loan and received in return a receipt designating the payment as "Interest on Annuity Loan Contract No. AX53651 to December 20, 1956." Following this payment the "cash or loan" value of the annuity contract had increased to $68,364. The petitioner received exactly that amount on December 27, 1951, and executed an agreement designated "Annuity Loan Agreement," providing for interest at 4 per cent per annum.

[1] The cases were tried separately in the Tax Court and argued separately in the Court of Appeals, but as the Tax Court relied on the reasoning in the Emmons case in disposition of both and as the facts differ in no material respect, we will consider them together. Cases reported below: W. Sinclair Emmons, Commissioner of Internal Revenue, 31 T.C. No. 4 (1958), reversed by full court (Circuit Judge Desmond writing separately); Carl F. Wolfe, Commissioner of Internal Revenue, 31 T.C. No. 5 (1958).

That same day Emmons repaid the bank the earlier loan, utilizing part of the proceeds of the annuity loan.

One year later, on December 31, 1952, Emmons paid Standard the additional amount of $8,039.64 and received a receipt indicating the payment was for "Annuity Loan Interest to December 20, 1959." The discount rate for prepayment of interest was 2.85 per cent. Thus, the second prepayment of interest increased the cash or loan value of the annuity contract to $73,728 and the increase of $5,361 was received by the taxpayer on the same day. Upon receipt, Emmons executed a second "Annuity Loan Agreement." At the date of the proceeding in the Tax Court the "loans" had not been repaid.

Emmons deducted the $13,627.30 payment as interest in his income tax return filed for 1951 and the $9,039.93 payment in his 1952 tax return. The Commissioner disallowed both deductions, insisting that (1) no indebtedness arose upon which payments of interest may be predicated, and (2) the payments constituted premiums rather than interest.

In arriving at its decision, which was reviewed by the full court, the Tax Court concluded that, despite the fact that the payments in question were in form interest within the meaning of Section 23(b) of the Internal Revenue Code of 1939, the entire transaction lacked substance and therefore was to be ignored for tax purposes.

The facts in the Weller case, except for dates and amounts, are practically the same.

Petitioners' attack on the judgments is essentially two-fold. They assert that the payments clearly constituted interest within the meaning of Section 23(b) and were therefore deductible under that section. Additionally,

they contend that the Commissioner may not, under the circumstances of these cases, retroactively reverse his prior rulings which allowed similar deductions.

Section 23 of the Internal Revenue Code of 1939, "Deductions from gross income," provides for deductions of "All interest paid or accrued within the taxable year on indebtedness * * *." The Supreme Court has defined the term interest as used in the Internal Revenue Code on several occasions. In Old Colony Railroad Co. v. Commissioner of Internal Revenue, 284 U. S. 552, 560 (1932), it was held to be "the amount which one has contracted to pay for the use of borrowed money." Again, in Deputy v. duPont, 308 U. S. 488, 497-498 (1940), the Court stated that "* * * although an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness' within the meaning of § 23(b). Nor are all carrying charges 'interest.' * * * We are dealing with the context of a revenue act and words which have today a well-known meaning. In the business world 'interest on indebtedness' means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense." Applying these definitions to the instant cases, we come to the crux of the government's case. It contends that since interest for tax purposes is confined to payments for the use of money and since no money or other economic benefit was ever in effect advanced to the taxpayers by the insurance company, the payments were not interest.

The Tax Court, and the government on appeal, rely quite heavily on the pattern of conduct evidenced by the taxpayer and Standard. This pattern, as summarized above, involved prepayments of interest which accelerated

the cash or loan value of the policy, concurrent borrowing of the accelerated increase in the cash or loan value, thus immediately recouping a major portion of the purported prepayments of interest. The cycle was completed when the taxpayer claimed deductions on his 1951 and 1952 returns of the entire amounts of each prepayment of interest, although his actual outlay was much less. We agree with the conclusion of the Tax Court that, although in form the payments appear to constitute interest within the meaning of Section 23(b) of the Internal Revenue Code of 1939, the entire transaction lacks substance.

Gregory v. Helvering, 293 U. S. 465 (1935), relied upon by the Tax Court, involved the creation of a corporate entity for the purpose of transferring shares of stock to the taxpayer. While recognizing that a real, valid corporate entity was created and that the transaction was within the terms of the statute, the Supreme Court concluded that it was "an elaborate and devious form of conveyance masquerading as a corporate reorganization." The activities were described as "an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business * * * but to transfer a parcel of corporate shares to the petitioner." The Court there also referred to the rule which excludes from consideration the motive of tax avoidance but determined that it was not pertinent to the situation "because the transaction upon its face lies outside the plain intent of the statute." The question of form versus substance as regards the incidence of taxation has been before the

courts on a number of occasions involving numerous differing factual situations. In Higgins v. Smith, 308 U. S. 473, 476 (1940), it was stated that "If * * * the *Gregory* case is viewed as a precedent for the disregard of a transfer of assets without a business purpose but solely to reduce tax liability, it gives support to the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration." See Griffiths v. Commissioner of Internal Revenue, 308 U. S. 355 (1939). In like vein the Supreme Court stated in Commissioner of Internal Revenue v. Court Holding Co., 324 U. S. 331, 334 (1945), "The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. * * * To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."

Any case of this nature is beset with difficulties, for in viewing the substance for the entire transaction one is faced with the rule alluded to above that enjoins us to disregard the motive of tax avoidance. That is not to say that we are confronted with a dilemma. Far from it. The proper resolution of the problem has succinctly been set forth by Judge Learned Hand in Gilbert v. Commissioner of Internal Revenue, 248 F. 2d 399, 411-412 (C. A. 2, 1957), (dissenting on a procedural matter unrelated to this case),

> "* * * If, however, the taxpayer enters upon a transaction that does not appreciably affect his bene-

> ficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose. * * * [The Gregory doctrine] covers only those transactions that do not appreciably change the taxpayer's financial position, either beneficially or detrimentally."

Thus, the principle laid down in the Gregory case is not limited to corporate reorganizations, but rather applies to the federal taxing statutes generally. The words of these statutes which describe commercial transactions are to be understood to refer to transactions entered upon for commercial purposes and "not to include transactions entered upon for no other motive but to escape taxation." Commissioner of Internal Revenue v. Transport Trading & Terminal Corp., 176 F. 2d 570, 572 (C. A. 2, 1949), cert. denied, 338 U.S. 955 (1950).

The Tax Court could find no independent economic purpose present in the instant cases and thus concluded that the sole purpose was the creation of a tax deduction. The petitioners have gone to great lengths to demonstrate that there was commercial substance to the transactions, over and above the tax benefits, but we are far from convinced. If one ignores the practice of concurrently borrowing the increased cash or loan value of the contracts built up by prepayments of interest one might find some economic sense in the transactions, other than the hoped for tax deductions. However, given the practice, which is borne out by the records, the fact that there was a 4 per cent interest rate on the loans and a mere 2.85 per cent discount rate on the prepaid interest, and the fact that the loans were non-recourse in nature and were never repaid, the conclusion of the Tax Court is a reasonable one.

Petitioners, on the other hand, point out that the insurance company, which was regularly organized and authorized to issue annuity contracts, and to make loans such as those made here, treated the payments on its books as interest received. The government does not challenge the validity of the labels employed by the insurance company nor does it contest the validity of the transactions under the Indiana insurance laws. Rather, it points to the well-settled principal that for the purpose of the federal tax laws, the substance of transactions is to be determined uniformly in relation to the meaning and intendment of the federal laws. United States v. Gilbert Associates, Inc., 345 U.S. 361 (1953). A denial of these claimed deductions would represent no attack in any way upon the insurance laws of Indiana or any other state in which Standard operates nor would it characterize it a "sham corporation" issuing "sham policies." That there may be an obligation which is valid under local law is not determinative of whether there is a true indebtedness within the meaning of Section 23(b). See Hellmuth & Ottenheimer Brewing Co. v. Commissioner of Internal Revenue, 116 F. 2d 465 (C.A.1, 1940), cert. denied, 313 U.S. 567 (1941).

Petitioners also place considerable emphasis upon the provisions and legislative history of Section 24(a)(6) which prohibits deductions for certain specified forms of interest, that is, "any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract . . . ." The fact that annuity contracts are not covered by this prohibition is clear beyond peradventure of a doubt. However, such a showing is far from determinative of the issue in the case for Section 24(a) applies to specific items that are *not*

deductible. The section does not even purport to indicate what items are deductible and, therefore, legislative history indicating that annuity contracts were specifically not included therein fails to conclude the issue. Regardless of Section 264(a)(4), the taxpayers' payments must still qualify as interest under Section 23(b) to be deductible.

In disallowing the interest in these cases, the department relied upon Revenue Ruling 54-94, 1954-1 Cum. Bull. 53, which, of course, was issued after the taxable years in question. The petitioners contend that the Commissioner may not retroactively reverse his prior rulings which allowed similar deductions. The prior rulings had not been issued to the petitioners, for they had never requested any but were individual rulings in other cases. These individual rulings had been shown to petitioners by insurance company salesmen prior to the time of the purchase of the annuity contracts. Recognizing that they may not rely on these rulings directly, petitioners maintain that all taxpayers have the right to be treated equally and fairly and since they undoubtedly would have received similar rulings had they applied for them, they are entitled to their benefits. They argue further that the very number of individual rulings made by the Commissioner established a practice, a course of conduct, and that a retroactive change would be an arbitrary exercise of the authority committed to the Commissioner by Congress.

2. Although there is no evidence in the record as to the number of such rulings made by the Commissioner, [illegible] of Mr. [illegible] testified that [illegible]

3. Section 264(a) provides:

"No deduction shall be allowed for any amount paid or accrued in connection with the purchase or carrying of any single premium life insurance, endowment or annuity contract, or any contract pursuant to a plan having substantially the same effect as a single premium contract, except that in the case of annuity contracts which are not single premium contracts the preceding sentence shall apply only to such contracts purchased after March 1, 1954." 26 U.S.C.A. (I.R.C. 1954) 264(a).

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The first contention has little substance or reason to support it, for it is just another way of stating that anyone who sees a ruling should be allowed to rely on it. Even with respect to rulings *published* in the Internal Revenue Bulletin, the Supreme Court said, in Helvering v. New York Trust Co., 292 U.S. 455, 468 (1934):

> "* * * The rulings * * * have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law. See cautionary notice published in the bulletins containing these rulings."

Certainly *unpublished* rulings can be given no greater effect.

In support of their second contention that it would be an abuse of discretion for the Commissioner to retroactively change his practice established by a series of individual rulings, taxpayers rely upon Automobile Club of Michigan v. Commissioner of Internal Revenue, 353 U.S. 180 (1957), and our case of Lesavoy Foundation v. Commissioner of Internal Revenue, 238 F. 2d 580 (C.A.3, 1956). Reliance upon the Lesavoy case is misplaced, for it merely determined that the Commissioner had exceeded his permissible discretion in retroactively withdrawing a ruling issued to a particular taxpayer who had not estopped himself. The Supreme Court in Automobile Club of Michigan v. Commissioner of Internal Revenue, *supra*, sets forth the standard which we must apply in questions of this nature. In that case the petitioner automobile club had received a ruling of exemption from the Commissioner in 1934 which was reconfirmed in 1938. In 1945, applying a new interpretation of the revenue laws rendered by the General Counsel, the Commissioner revoked this individual ruling and applied

his revocation retroactively to tax years 1943 and 1944. The revocations applied to exemptions issued to all automobile clubs and the Supreme Court stated, at page 186, "that the Commissioner, having dealt with petitioner upon the same basis as other automobile clubs, did not abuse his discretion." Similarly in the instant cases, the petitioners have been treated in the same manner as all other taxpayers.

Petitioners contend, however, that although the revenue ruling fails to indicate any limitation on its application, agents of the Treasury have stated to Congress that it does not intend to apply the revenue ruling retroactively to individuals who have previously been issued rulings. We need not determine whether such action if carried out would be an abuse of discretion, for petitioners are not in the same position as those parties who have been issued rulings. They are entitled to the same treatment as all other taxpayers similarly situated, i.e., without ruling no rights and no facts. Thus the Commissioner has afforded them

Petitioners' further arguments are adequately disposed of by Automobile Club of Michigan v. Commissioner of Internal Revenue, supra.

We are not unmindful of the decision to reply rendered by the Court of Appeals for the Fifth Circuit in a similar case, United States v. Reed, 258 F. 2d 577 (1958), which holds contrary to this opinion. We agree, however, with the dissenting opinion of Judge Wisdom in that case. In accord with our opinion are Haggard v. United States, 204 F.S.T.C. ¶9299 (D.C. Ariz. 1959) and Kessler v. United States, 58-2 U.S.T.C. ¶9655 (S.D. Calif. 1958). And see Goodstein v. Commissioner of Internal Revenue, 267

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F. 2d 127 (C.A.1, 1959); Sonnabend v. Commissioner of Internal Revenue, 267 F. 2d 319 (C.A.1, 1959).

The judgments will be affirmed.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

APPENDIX B

STATUTES INVOLVED

Internal Revenue Code of 1939:

"SEC. 24. ITEMS NOT DEDUCTIBLE.

"(a) GENERAL RULE. In computing net income no deduction shall in any case be allowed in respect of

* * *

"(6) Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purposes of this paragraph, if substantially all the premiums on a life insurance or endowment contract are paid within a period of four years from the date on which such contract is purchased, such contract shall be considered a single premium life insurance or endowment contract; * * *"

"SEC. 3791. RULES AND REGULATIONS.

* * *

"(b) RETROACTIVITY OF REGULATIONS OR RULINGS.—The Secretary, or the Commissioner with the approval of the Secretary, may prescribe the extent, if any, to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect."

Internal Revenue Code of 1954:

"SEC. 163. INTEREST.

"(a) GENERAL RULE. There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

"SEC. 264. CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS.

"(a) GENERAL RULE. No deduction shall be allowed for—

* * *

"(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

"Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954."

"Sec. 7805. Rules and Regulations.

* * *

"(b) Retroactivity of Regulations or Rulings. The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect."